

# [Chinese fixed income markets](https://assignbuster.com/chinese-fixed-income-markets/)

The Chinese fixed income market, particularly corporate bonds of all Investment grades, should be predicated on both a preexisting system of adequate legal protections afforded to creditors, and to providing a conduit through which signaling information can be funneled to potential investors in the secondary market. We often think of creditors and investors as one in the same in the bond markets but the distinction here recognizes those investors, as a segment of the market, who have in fact lent; and those investors, as another segment, whose decision to lend is effectively “ on the margin.

Reformation of the banking system and enforceable liquidation preference are prerequisites for an environment that maximizes all available and potential supply and demand of and for Chinese corporate bonds.

The extent to which these structural issues are not remedied is the extent to which there remains the potential for deadweight loss and money that is essentially “ left on the table. ” On the supply side of the equation, Chinese corporate have traditionally accessed debt capital through bank credit.

More than half of the loans in China are made by an oligopoly of four “ policy’ banks. But all Chinese banks are state- controlled lenders, the larger of which typically have minority floats traded on the Hong Kong stock exchange. The Chinese central government holds controlling stakes in all of its public banks. Banks are run by political appointees placed by the Communist Central Party.

Surprisingly, this structure may come with some advantages for foreign shareholders – a collapse in shareholder value would be a political embarrassment for China.

Large foreign reserves give regulators ample Juice to finance any politically palatable bailouts, If necessary. Financial reformists once itched the Idea of taking the banks public as a means of attracting foreign capital, foreign management expertise, and market monitoring against corruption. After China was admitted to the World Trade Organization, however, these reformist ideals have since faded.

Domestic banks operate at the behest of the state; capital directed to bloated state-owned enterprises must be deployed, despite any market indications of imprudence In doing so.

The Chinese central bank under the auspice of the PRE State Council has absolute authority to set Interest rates for commercial banks (as opposed to, say, the us Federal Reserve, which sets a target federal funds rate for interbrain loans and a higher discount rate in its capacity as a lender of last resort). This isn’t to say that all Chinese borrowers get the same rate – political favors can be divvied out in the absence of, or potentially at the order of, central bank fiat.

Interception loans made directly to onshore entitles are prohibited if that lender is not a registered – and thus under the Jurisdiction of the Central Bank of China – financial Institution.

Protectionist laws such as this one ensure that “ entrusted loans,” which utilize the services of a Chinese intermediary bank, even where there is no dearth in capital supply, earn banks a cushy transaction fee as well as further the informational advantage that banks in China already enjoy.

Keeping this hostile environment in mind, let us now examine why firms should theoretically prefer to borrow in the bond market rather than take loans from Chinese banks. First, Chinese banks do not perform In-depth credit analyses of prospective borrowers, which hurts subsidize the monitoring costs incurred by riskier firms that are then passed onto hem through the lender.

Second, corporate bond issuance conveys information about management’s view of that firm to the market – the market’s acceptance or rejection of which, among other things, can undermine the monopoly of information that banks have over a borrower, thereby decreasing opportunistic rent-seeking, whereby banks tax firms in light of having that leverage.

As such, Chinese corporate are unlikely to increase debt issues until China’s financial system is functioning more as a competitive market.

Since Chinese banks engage in inadequate credit analysis, it s difficult for firms to garner a creditworthy reputation for servicing their debtor obligations and also makes the interest rates charged insensitive to past credit history. Without an opportunity to develop a reputation as borrowers, the bond market cannot price yields efficiently so as to potentially reward creditworthy firms with a lower cost of debt capital, thus squashing the incentive for issuers to enter the bond market. Moreover, there are many so called “ pre-bankable” private firms that are effectively shut out of the bond market altogether because of no credit history.

Ultimately, it is banks’ collective failure to price commercial loans efficiently – that is, by credit spread that leads to a limping bond market. If interest rates cannot fluctuate, the invisible hand of competition cannot enter the market to lower the cost of debt capital to creditworthy firms after information about the firm has hit the market.

Thus, the bond market itself has no competitive advantage over the credit market. Only once the banking system is decentralized and privatized can the forces of the market be allowed to operate freely.

China should allow commercial banks to et their own interest rates and allow market discipline to force lenders into critical evaluations of borrower’s credit histories. On the demand side of the equation, Chinese fixed income markets need to lower the barriers to entry for foreign investors because local demand will probably remain inadequate for some time. China still needs to develop institutional investors with the appetite to diversify holdings with corporate bonds. Statutory restrictions imposing limits, such as those binding the National Social Security Fund, on corporate bond holdings are not helpful n this regard.

It is likely, though, that these institutions will continue to develop as China makes its transition to a market economy, and consequentially the domestic demand for corporate bonds will grow and become more liquid. However, in order to entice the available supply of foreign investors eager to be a part of the world’s second largest economy, adequate legal protections must give those investors the confidence that they can recover at least some of their potential investments in liquidation or reorganization.

This is especially true for foreign investors – the market segment that, again, will likely be the driving force of the demand side at least for the short-term – who under current bankruptcy laws, or the under the standards and practices of local courts in enforcing those laws, find it very difficult to ensure equal protection enjoyed by their local counterparts. The custom of foreign investors buying notes issued instead by offshore parents of Chinese subsidiaries has arisen to help mitigate recruitment risk.

However, that solution, too, is not without its problems. When foreign investors lend to offshore parents, capital then flows from he offshore entities onshore in the form of an interception (entrusted) loan.

If the claim on its subsidiary assets to recover the proceeds of that loan. Effectively, this turns the foreign bondholders into equity holders of the parent, but without the upside potential associated with equity ownership.

Even with registration of interception loans with the State Administration of Foreign Exchange, domestic creditors can obtain the equivalent of lien to circumvent priority, under a plethora of dubious rationales (reasoning, for instance, that the credit event was the result of or offshore management practices and by extension poor monitoring efforts of foreign bondholders, rather than the fault of domestic operations).

Thus, offshore creditors must create leverage ex ante to protect themselves, such as mandating the invoice of accounts receivables through the offshore parent accounts as security for the bonds. In the aggregate, this hassle and unfair balancing of risk amounts to inordinate transaction costs, which serve nothing other than to impede the development of China’s fixed income markets in the name of facial protectionism. An effective bankruptcy regime lowers the cost of corporate borrowing and increases aggregate allocation of capital.

China’s bankruptcy law might be structurally sound, but its operational enforcement is rife with corruption and favoritism compounded by a top-down approach of single-party governance in which decisions are made based on what is in the country’s interest rather than on equal, consistent, or fair application of the laws that are in place. China needs its courts to enforce the bankruptcy laws that it has on its books without regard to the claimant’s nationality.